

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Date [REDACTED]

Surname [REDACTED]

Contact Person: [REDACTED]

Telephone Number: [REDACTED]

In Reference to: [REDACTED]

Date: [REDACTED]

Employer Identification Number: [REDACTED]

Key District Office: [REDACTED]

Dear Applicant:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(4). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

You were incorporated under the laws of the State of [REDACTED] on [REDACTED] for the delivery of health care to the public and to engage in the instruction of the general public in the area of medical science, public health, and hygiene and related instruction useful to the individual and beneficial to the community served by you.

Article V of your Articles of Incorporation provides that there shall be two classes of members: Class A and Class B. Class A members must be licensed physicians who are actively engaged in the practice of medicine and who are members of the active or provisional medical staff of [REDACTED]. Class A members who practice medicine primarily outside of [REDACTED] must be members in good standing of a medical staff of a hospital with clinical privileges to practice at such hospital. Class B member shall be [REDACTED]. Class B member may withdraw as member if any law, rules and regulations governing it and its participation are detrimental to it or on the second anniversary of the incorporation of the corporation and on any subsequent anniversary date, by giving at least ninety day prior written notice. Upon such withdrawal, the Class A members shall continue as sole members of the corporation.

Article VI of your Articles of Incorporation provides that the management of the corporation shall be vested in a board of directors comprised only of Class A members. The number of

directors shall be no less than 3 and no more than 11. The present Board of Directors consists of 6.

Article III, section 5 of your Bylaws provides, in part, that only class A members shall be qualified to serve as directors or officers of the corporation. Art. VI section 2 provides that all officers must be Class A members.

Article IV, section 5 of your Bylaws provides that all elections of directors shall be decided by a majority of the Class A members, subject to the approval of the Class B member.

Article V, section 5 of your Bylaws provides that no person may serve as a director if (a) he is primarily engaged in the practice of medicine as a faculty member of a medical school, college or university or is employed as a full time faculty member of a medical school, college or university, or (b) he serves as an officer or as a member of the governing body of any hospital or entity which owns or operates a hospital in [REDACTED] or [REDACTED] Counties, other than [REDACTED].

You state that as of [REDACTED] you have [REDACTED] Class A members. All members are individual physicians but may be affiliated via a group practice arrangement. There is no limit on Class A members and each is given a vote on agenda items in the annual meeting. Your Bylaws provide that membership dues are \$[REDACTED] for the first year of membership. Thereafter, dues shall be determined by the Board of Directors.

You state that for the [REDACTED] tax year total membership income was \$[REDACTED]. New physician members, Class A, paid a total of \$[REDACTED] and [REDACTED] Class B membership, paid a total of \$[REDACTED]. For [REDACTED] and from [REDACTED] to [REDACTED] you received membership income from Class A members in the sum of \$[REDACTED] and \$[REDACTED], respectively.

With respect to sources of financial support, you state that each member pays an initial membership assessment of \$[REDACTED]. Providers establishing a practice in [REDACTED] County and who apply within 6 months of establishing their practice may join at a discounted assessment of \$[REDACTED]. You state that [REDACTED] is the only Class B member and provides [REDACTED] of your financial support. You also indicate that as the organization develops, sources of funding will include access charges paid by employers to you; access charges paid by non-physician contract providers for marketing and administration; and payments by providers for billing and collection functions.

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You state that you propose to develop an integrated health care delivery system comprised of physicians, hospitals and other providers who will work together to offer residents of the [REDACTED] a comprehensive range of services directed to the prevention, diagnosis, treatment and rehabilitation of illness and injury.

You state that through the development of an integrated network you work with local employers and other third party payors to develop delivery models including clinic, inpatient and outpatient which meet their needs. You further state that as your membership learns the principles of managed care, you work to incorporate these precepts into the delivery of health care throughout the Permian basin. You state that key areas of focus include:

- a. Streamlined referrals between primary care and specialists, both local and in the rural areas of the [REDACTED]
- b. Taking a pro-active role in structuring a flexible and affordable health plan for small businesses of the [REDACTED]
- c. Development of an information system that will review practice and referral patterns of the membership in hopes of identifying opportunities to improve care.
- d. Offering educational seminars to the membership on ways to improve their practices.
- e. Sponsoring community educational seminars on key health related topics.
- f. Working on an individual physician basis to improve outcomes and patient satisfaction.

A letter from the [REDACTED] Administrator states that you provide a forum for the [REDACTED] staff physicians to assume a role of leadership to develop a model of integration services which meets their needs. The Administrator states that the Board and Hospital Administration support your efforts by providing capital as well as support staffing for this venture. The Hospital has also agreed to support your contracting efforts by providing a discount package to those purchasers of care who contract with you. It further states that the added incentive of Hospital discounts will significantly improve your marketing position.

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[REDACTED]

You state that [REDACTED] as Class B member, contracts with many payors concurrently with you. You state that all contracting is, however, conducted separately. [REDACTED] holds no contracts directly through you but, will negotiate with purchasers which affiliate with you. You have provided copies of several contracts to which [REDACTED] is a party.

You state that you may utilize some of the facilities and employees of [REDACTED] pursuant to an Administrative Service Agreement between you and the Hospital. However, you neither discussed the terms of the agreement nor did you submit a copy of the agreement.

In a sample copy of a physician Provider Participation Agreement, under Recitals, you state that you desire to create a panel of providers who agree to comply with the reimbursement and utilization management methodology established by you, and who will participate in and comply with the policies and procedures adopted by you and contracted payors. You will offer, independently and in conjunction with others, to payors the opportunity to participate in a managed care plan that utilizes the services of the provider panel.

Definitions in the Agreement include the following:

Covered persons - those employees or members and their dependents who have elected to receive care from participating providers and who are covered by a benefit plan insured, provided, or administered by the payor.

Covered services - all services within provider's capabilities that provider is licensed to provide and that are rendered to a covered person by provider for which payor is obligated to pay or reimburse pursuant to the benefit plan insured, provided, or administered by the payor.

Payor Agreement - agreement between you and a payor whereby a payor agrees to offer to covered persons one or more payor plans and you agree to arrange for the provision of covered services specified in such plan.

Participating Provider - a licensed professional, practitioner, legal entity, or facility that has entered into a written agreement with you to participate in any provider panel established by you and to comply with the reimbursement mechanisms and utilization management procedures established by you and/or payor.

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Payor - any company, including but not limited to employers, union groups, associations, insurers, and HMOs that have contracted with you to use any program established by you and/or payor.

Payor Plan - all programs established by you with any payor, involving a panel of participating providers that has been selected by you and that has agreed to comply with certain reimbursement mechanisms and utilization management procedures established by you and/or payor.

Your duties under the agreement generally are to market a provider network to payors and furnish provider a summary of terms and conditions of each payor agreement in which provider participates (payment terms, utilization review requirements, claims filing procedures). You will also obligate payor to make payments to you on behalf of provider for covered services rendered by provider to covered persons; to make payments for covered services on the basis of a reimbursement methodology negotiated by you and communicated to and accepted by provider; to make payments to you on behalf of provider within thirty days after receipt of a completed claim form from provider, unless otherwise agreed by you and a specific payor; to provide a convenient means for provider to identify covered persons of a payor plan and services applicable to each.

You state that you market your services directly to large employers as well as via printed advertisements. All marketing is directed at the employer or the employer's insurance carrier and other purchasers of care. You do not market directly to beneficiaries. You state that you also market jointly with such plans as the [REDACTED] Plan. The agreement between you and [REDACTED] is dated [REDACTED]. Under the contract, your physician members and [REDACTED] will provide services to [REDACTED] covered persons at the negotiated rates. Pursuant to the claims procedures, you shall direct all participating providers to forward all claims for covered persons directly to [REDACTED]. Article V provides that both parties acknowledge your intent to work with [REDACTED] toward the goal of your assumption of a portion of the risk pursuant to a mutually agreeable Profit Sharing Agreement. Section 5.2 provides that both parties agree that the Profit Sharing Arrangement shall be negotiated at a later date. You did not provide a copy of the Profit Sharing Arrangement.

You state that you are currently affiliated with [REDACTED], [REDACTED], [REDACTED], and [REDACTED]. However, you did not provide copies of contracts with these organizations in which you are a

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[REDACTED]

party. Copies of contracts provided are those wherein [REDACTED] is the contracting party for providing hospital services.

Regarding your negotiations with [REDACTED] of [REDACTED] for the provision of your [REDACTED] physician services, you state that you have been approved as a network provider for [REDACTED]. Providers participate on a fee for service basis with a withhold of [REDACTED] % payable upon achievement of performance targets. [REDACTED] participates on a diagnosis related grouping (DRG) basis. All providers bill [REDACTED] directly and receive payments directly. You did not provide a copy of this agreement.

Section 501(a) of the Code exempts from federal income tax, among others, organizations described in section 501(c)(4). Section 501(c)(4)(A) includes civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare. Subparagraph (B) provides that subparagraph (A) shall not apply to an entity unless no part of the net earnings of such entity inures to the benefit of any private shareholder or individual.

Section 1.501(a)-1(c) of the Income Tax Regulations defines "private shareholder or individual" as persons having a personal and private interest in the activities of the organization.

Section 1.501(c)(4)-1(a)(2)(i) of the regulations provides that an organization is operated exclusively for the promotion of social welfare if it is primarily engaged in promoting in some way the common good and general welfare of the community. An organization embraced within this section is one that is operated primarily for the purpose of bringing about civic betterment and social improvements.

Section 1.501(c)(4)-1(a)(2)(ii) of the regulations provides, in pertinent part, that an organization is not operated primarily for the promotion of social welfare if its primary activity is carrying on a business with the general public in a manner similar to organizations which are operated for profit.

The determination of whether an organization qualifies for exemption from federal income tax under section 501(c)(4) of the Code is essentially a factual question. If an organization is used to channel private economic benefits to its members the organization is not exempt under section 501(c)(4).

Revenue Ruling 73-349, 1973-2 C.B. 179, describes an organization operated on a cooperative basis to provide groceries

to its members at the lowest possible prices. The revenue ruling concludes that the organization is a private cooperative enterprise for the economic benefit or convenience of the members and any benefits to the community are not sufficient to meet the requirement of the regulations that the organization be operated primarily for the common good and general welfare of the people of the community. Therefore, the organization does not qualify for exemption under section 501(c)(4) of the Code. This revenue ruling cites the similar holding of Commissioner v. Lake Forest, Inc., 305 F.2d 814 (4th Cir. 1962), where the court held that the provision of housing on a cooperative basis was a private self-help enterprise with only an incidental benefit to the community as a whole.

Revenue Ruling 70-535, 1970-2 C.B. 117, describes an organization formed to provide management, development and consulting services for low and moderate income housing projects for a fee. The ruling held that the organization did not qualify under section 501(c)(4) of the Code. This revenue ruling stated: "Since the organization's primary activity is carrying on a business by managing low and moderate income housing projects in a manner similar to organizations operated for profit, the organization is not operated primarily for the promotion of social welfare."

Revenue Ruling 72-369, 1972-3 C.B. 245, describes an organization formed to provide management and consulting services at cost to unrelated exempt organizations. This revenue ruling stated: "An organization is not exempt merely because its operations are not conducted for the purposes of producing a profit.... Providing managerial and consulting services on a regular basis for a fee is a trade or business ordinarily carried on for profit."

You are similar to the organizations described in revenue rulings 73-349, 70-535 and 72-369, cited above, in that by negotiating managed care contracts for your physician members and developing health care delivery models for third party payors, as described above, you are engaging in a business activity ordinarily carried on for profit and conducted for the benefit of your members and other private interests. Providing ordinary commercial services for a group of health care providers does not directly promote health nor does it provide a broad community benefit.

Contracting Plumbers Cooperative Restoration Corporation v. United States, 488 F.2d 684, 686 (2d Cir. 1973), cert. denied, 419 U.S. 827 (1974), describes an organization whose sole purpose is to insure the efficient repair of "cuts" made in the streets

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[REDACTED]

of New York City by the organization's members in the course of their plumbing activities. Prior to the organization's formation, city employees had repaired such cuts, billing the responsible plumber accordingly. This municipal restoration program was highly inefficient, subjecting the community to the dangers of -- and the plumbers to the corresponding liability for -- improperly filled excavations for prolonged periods. Moreover, this inefficient program was resulting in a large annual operating loss to the city.

After negotiating with the city, the plumbers were authorized to conduct their own restoration program through the organization, a non-profit cooperative. The organization performed efficiently; the average restoration time was reduced to approximately fourteen days and the organization was able to turn a modest profit.

Relying on the organization's nonprofit nature, its public origins, and its undisputed benefit to the residents of the city, the district court held that the organization was exempt as an organization described in section 501(c)(4) of the Code. The court found that the organization's value to the community and to its individual members was "indistinguishable."

The court of appeals disagreed. Among the factors considered by the court of appeals was the fact that the organization did not repair the equally troublesome potholes left by the few remaining nonmember plumbers or the other, more numerous enterprises that burrow into the city streets. Additionally, the members of the organization enjoy the economic benefits precisely to the extent that they use, and pay for, its restoration services. The court felt that this conditional benefit most distinguished Contracting Plumbers from Monterey Public Parking Corporation v. United States, 321 F.Supp. 972, aff'd, 481 F.2d 175. In Monterey, the court held that a private non-profit parking lot financed by local merchants was exempt under section 501(c)(4) of the Code -- but only because its organizers had not exploited the facility by giving themselves special advertising rights, or by restricting the validation stamp system to certain businesses. The court recognized that such limitation would have demonstrated that the merchants "were in fact primarily interested in their own ends rather than those of the public."

In Contracting Plumbers, the court of appeals found that the organization provided substantial and different benefits to both the public and its plumber members. Thus, it held that the organization was not primarily devoted to the common good as required by section 501(c)(4).

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Revenue Ruling 86-98, 1986-2 C.B. 74, describes an individual practice association ("M") formed to provide health services through written agreements negotiated with health maintenance organizations ("HMOs").

M's membership is limited to licensed physicians who are engaged in the active practice of medicine and who are members of a specified county medical society. The activities of M are managed by an executive committee which is elected by the membership of M. The bylaws of M require that a majority of the executive committee be members of M.

M's primary activities are to serve as a bargaining agent for its members in dealing with HMOs, and to perform the administrative claims services required by the agreements negotiated with the HMOs. M is paid a capitation amount by each HMO based on the number of HMO subscribers entitled to receive medical services. Members bill M for services rendered to the HMO subscribers and accept claims payments for M as payment for services rendered.

M's income is derived from its contracts with HMOs and its expenditures are for administrative costs and payments to its members.

The main functions of M are to provide an available pool of physicians who will abide by its fee schedule when rendering medical services to the subscribers of an HMO, and to provide M's members with access to a large group of patients, the HMO subscribers, who generally may not be referred to nonmember-physicians. M negotiates contracts on behalf of its members with various HMOs, administers the claims received from its members, and pays them according to its reimbursement agreement.

Revenue Ruling 86-98 states that these facts indicate that M is akin to a billing and collection service and a collective bargaining representative negotiating on behalf of its member-physicians with HMOs. In addition M does not provide to HMO patients access to medical care which would not have been available but for the establishment of M.

Thus, the revenue ruling holds that M operates in a manner similar to organizations carried on for profit, and its primary beneficiaries are its physician members rather than the community as a whole. Therefore, M does not qualify for exemption from federal income tax as a social welfare organization under section 501(c)(4) of the Code.

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You are essentially an independent practice association like the one described in Revenue Ruling 86-98, above, with the addition of a hospital participant. You are similar to the organization described in the revenue ruling in that you are controlled by your physician members, you provide no health care services, and you act as a bargaining agent for your physician members in negotiating managed care contracts with self-insured employers, HMOs, and other third party payors, thus providing your members with an expanded patient base. The direct benefits of your activities thus flow to private individuals engaged in the for profit practice of medicine rather than to the community as a whole.

Based on the facts above, you are not engaging in the practice of medicine or operating a hospital. You are merely negotiating managed care and physician care contracts for your physician members which serves the private interests of the physicians rather than the interests of the community as a whole. You also work with local employers and other third party payors in developing health care delivery models which meet the private interests of such employers and third party payors rather than the needs of the community. Further, your physician members are "private individuals" as defined in section 1.501(a)-1(c) of the regulations. Your physician members receive prohibited private benefit which may include an advantage, profit, fruit, privilege, gain or interest. See Retired Teachers Legal Defense Fund v. Commissioner, 78 T.C. 280, 286 (1982). The substantial private benefit to your physician members is fatal to your exempt status. Also, physician members who serve on your governing board are "insiders" subject to the inurement proscription. Therefore, the same activities that constitute private benefit to your physician members result in prohibited inurement to those physician members who serve on your governing board.

Based on all the facts and circumstances, we conclude that you are not operated primarily for the promotion of social welfare. Accordingly, you do not qualify for exemption as an organization described in section 501(c)(4) of the Code and you must file federal income tax returns.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that

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person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If we do not hear from you within 30 days, this ruling will become final and copies will be forwarded to your key district office. Thereafter, any questions about your federal income tax status should be addressed to that office.

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

[REDACTED]

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

[REDACTED]
[REDACTED]
Chief, Exempt Organizations
[REDACTED]

cc: [REDACTED]
[REDACTED]
[REDACTED]

[REDACTED]

[REDACTED]